



STATE OF WASHINGTON

## ECONOMIC AND REVENUE FORECAST COUNCIL

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October 27, 2006

**TO:** Governor's Council of Economic Advisors

**FROM:** ChangMook Sohn, Executive Director  
Economic and Revenue Forecast Council

**SUBJECT: PRELIMINARY NOVEMBER ECONOMIC FORECAST**

This preliminary forecast was based on Global Insight's October Control forecast for the U.S. economy. You should have received a summary of the Global Insight forecast by email. If not, please contact our office. The forecast was produced prior to the advance GDP estimate for the third quarter of 2006. The discussion that follows relates to the third quarter forecast rather than the advance GDP release. According to the forecast, real GDP growth slowed to 1.7 percent in the third quarter from 2.6 percent in the second quarter. Final sales growth improved slightly, however, from 2.1 percent to 2.3 percent. What little growth there was in the third quarter was mainly due to consumers whose spending increased at a 3.0 percent rate in the third quarter. Fixed investment declined at a 1.7 percent rate in the third quarter following a 1.6 percent decline in the second quarter. The 19.6 percent drop in residential fixed investment more than accounted for the overall decline in fixed investment and subtracted more than a full percentage point from overall GDP growth.

According to the forecast, payroll employment growth slowed to 1.1 percent in the third quarter from 1.2 percent in the second quarter and 1.7 percent in the first quarter. The unemployment rate rose slightly to 4.73 percent in the third quarter from 4.63 percent in the second quarter. Inflation, as measured by the Consumer Price Index, slowed to 2.8 percent in the third quarter of 2006 from 5.0 percent in the second quarter. The improvement was largely due to energy costs which edged up only 0.9 percent in the third quarter after soaring 25.0 percent in the second quarter. Core inflation, which excludes food and energy, slowed from 3.5 percent to a still worrisome 2.9 percent. Housing starts plummeted at a 32.5 percent rate in the third quarter to 1.697 million units following an even sharper 39.5 percent decline in the second quarter. The mortgage rate was essentially unchanged in the third quarter at 6.57 percent compared to 6.60 percent in the second quarter. As expected, the Federal Reserve left its target for the federal funds rate unchanged at 5.25 percent in September.

The new national forecast anticipates considerably lower oil prices than the forecast adopted in September. The main result of the plunge in oil prices is lower inflation in 2006 and 2007. Interest rates are also significantly lower in the new forecast. Real GDP and employment growth are essentially unchanged in 2006 and 2007 but slightly stronger in 2008 and 2009. The new personal income forecast for 2006 has been substantially increased but this is entirely due to the extraordinary wage growth in the first quarter revealed by the newly available Quarterly Census of Employment and Wages (QCEW) data. The pattern of income growth after the first quarter is actually somewhat weaker than assumed in September. The forecast assumes the Federal Reserve

will hold the federal funds rate steady until March at which time it will implement the first of three 25-basis point cuts in 2007.

A comparison of the preliminary U.S. forecast with the forecast adopted in September is shown in Table 2.

The Washington aerospace employment forecast is virtually unchanged since September. As of September, the aerospace sector has added 13,400 jobs since the trough in May 2004. The forecast expects another 6,200 new aerospace jobs by mid-2008 when employment is expected to level off at 80,400. This is still 32,700 (28.9 percent) lower than the previous peak in June 1998. Software employment is expected to grow about 6,200 from now through the end of 2009 which translates into a growth rate of 1,900 jobs per year. Higher interest rates will have an adverse impact on the Washington housing market but this will be offset by strong population growth. In addition, nonresidential construction is expected to grow. Overall Washington construction employment is expected to continue to expand but at a much reduced rate.

The employment forecast incorporates very preliminary Quarterly Census of Employment and Wages (QCEW) data for the second quarter of 2006. The official data available from the Department of Employment Security will reflect the second quarter QCEW in November after it undergoes further editing. The benchmark revision to the second quarter raised the estimate of June employment by 15,800. Employment growth from June through September was 3,100 less than expected, however, leaving September's employment still 12,800 higher than expected in the September forecast. The revised employment data indicate that employment was growing at about 3 percent per quarter in the second and third quarters of 2006 rather than about 2 percent as assumed in September.

We also have the QCEW wage data for the second quarter of 2006 which was unavailable to the BEA at the time of their latest personal income release. As a result, our estimates of wages in the second quarter differ from the published BEA estimates. In addition, an error has been discovered in the BEA estimates for "employee and self-employed contributions for government social insurance" which we have attempted to correct. Our correction affects the data from 2003 onward. The QCEW data indicate that second quarter wages were \$1.131 billion (0.8 percent) lower than expected in September. Software wages were \$0.011 billion (0.2 percent) lower than expected and other wages were \$1.120 billion (0.9 percent) lower. Nonwage personal income was \$0.818 billion (0.8 percent) below the September estimate. The downward revision in nonwage income mainly reflects the annual revision to the national income a product accounts. The annual revision resulted in much lower estimates for "employer contributions for employee pension and insurance funds" which were largely offset by much higher estimates for "dividends, interest, and rent." The revision to total personal income in the second quarter was reduction of \$1.949 billion (0.8 percent).

The forecast also reflects Seattle consumer price data through August. After trailing the national average during 2002, 2003, and 2004, December-December Seattle core inflation (excluding food and energy) edged ahead of the national average, rising 2.3 percent compared to 2.2 percent. During the first eight months of 2006 core inflation in Seattle rose at an annual rate of 3.4 percent compared to 3.0 percent for the U.S. city average. The overall Seattle CPI rose at an annual rate of 5.0 percent in the first eight months of this year compared to the 4.6 percent national average.

The number of housing units authorized by building permit edged up 1,000 in the third quarter of 2006 to 52,200 from 51,200 in the second quarter. Single-family permits declined 2,100 to 33,200 but multi-family permits rose 3,100 to 19,000.

A comparison of the preliminary Washington forecast with the forecast adopted in September is shown in Table 3.

Review of the forecast by the Governor's Council of Economic Advisors is scheduled for Friday, November 3, 2006 at 10:00 a.m., in the Governor's Conference Room.

If you have any questions, please contact Bret Bertolin, Senior Economic Forecaster, at (360) 570-6106.

**PLEASE NOTE:**

Enclosed is a worksheet summarizing the preliminary forecast. **Council members are strongly encouraged to complete and return this worksheet either in person at the Governor's Council meeting or, if unable to attend, by FAX to (360) 753-7022.** This worksheet is relied on by the Forecast Council members and staff to gauge the reasonableness of the preliminary economic forecast and also serves as the basis of an alternative economic and revenue forecast.

Fluctuations in software wages cause significant distortions in overall wage and personal income trends. In particular, Microsoft's stock awards vest in the third quarter of each year. Microsoft also pays bonuses in the third quarter. Since the Bureau of Economic Analysis does not seasonally adjust software wages, this causes an apparent jump in wages in the third quarter of each year and drop in the fourth quarter. Other quarters are less affected. Also, Microsoft stock option income can vary widely from quarter to quarter and from year to year. The following table shows what growth would have been without these factors.

	2006Q4	2006	2007	2008	2009:1,2
<u>Real Personal Income, %Ch.</u>					
Baseline	0.6	5.0	4.5	4.8	4.2
Excluding Software	6.5	4.8	4.4	4.7	4.8
Difference	-6.0	0.2	0.1	0.0	-0.6
<u>Average Annual Wage, %Ch.</u>					
Baseline	-6.7	6.1	3.5	4.1	3.2
Excluding Software	3.7	5.8	3.3	4.0	4.3
Difference	-10.4	0.3	0.2	0.1	-1.1

CMS: bb  
Enclosures

Table 1

**U.S. Economic Forecast Comparison**

October 2006

	2006Q3	2006Q4	2007Q1	2007Q2	2006	2007	2008	2009
<b>Real GDP, Percent Change</b>								
Global Insight	1.7	2.6	2.3	2.4	3.3	2.4	3.3	3.3
Blue Chip	2.3	2.4	2.6	2.7	3.4	2.6		
Economy.com	2.4	2.7	2.8	2.9	3.4	2.8		
S&P	2.3	2.7			3.4	2.3	2.8	3.1
Merril Lynch	1.5	2.5	2.3	1.5	3.3	2.0		
<b>Federal Funds Rate</b>								
Global Insight	5.25	5.25	5.22	5.00	4.96	4.83	4.50	4.69
Blue Chip*	5.2	5.5	5.4	5.3	5.0	5.1		
Economy.com	5.3	5.3	5.1	4.8	5.0	4.8		
S&P	5.2	5.3			5.0	5.0	4.8	4.8
<b>Consumer Price Index, Percent Change</b>								
Global Insight	2.8	-1.3	3.7	2.3	3.3	2.2	2.0	1.8
Blue Chip	3.2	1.7	2.7	2.5	3.5	2.5		
Economy.com	2.8	1.7	2.3	2.8	3.5	2.4		
S&P	2.8	-1.3			3.3	2.2	2.0	1.7
Merril Lynch	3.2	-0.9	1.4	1.6	3.3	1.5		
<b>Payroll Employment, Millions</b>								
Global Insight	135.5	135.8	136.2	136.5	135.3	136.7	138.7	140.9
Economy.com	135.5	135.8	136.1	136.4	135.3	136.6		
S&P	135.6	136.0			135.3	136.8	138.4	140.2
<b>Unemployment Rate, Percent</b>								
Global Insight	4.7	4.8	4.9	4.9	4.7	5.0	4.9	4.7
Blue Chip	4.7	4.8	4.9	4.9	4.7	4.9		
Economy.com	4.8	4.8	4.9	4.9	4.7	4.9		
S&P	4.7	4.8			4.7	4.9	5.1	5.0
Merril Lynch	4.7	4.8	5.0	5.3	4.7	5.4		
<b>Real Disposable Personal Income, Percent Change</b>								
Global Insight	4.1	4.9	3.0	2.6	3.3	3.4	3.9	3.8
Blue Chip	3.2	3.6	3.4	2.9	3.0	3.1		
Merril Lynch	3.0	4.1	3.6	1.6	3.1	2.7		

\* Estimate based on T-bill rate.

Table 2

**U.S. Forecast Comparison**

	2006Q1	2006Q2	2006Q3	2006Q4	2007Q1	2007Q2	2005	2006	2007	2008	2009
<b>Real GDP (Billions of Chained 2000 Dollars)</b>											
November	11316.4	11388.1	11435.0	11508.8	11574.0	11641.5	11048.6	11412.1	11681.1	12066.4	12468.2
Percent Change	5.6	2.6	1.7	2.6	2.3	2.4	3.2	3.3	2.4	3.3	3.3
September	11316.4	11385.3	11451.4	11514.8	11575.0	11651.1	11048.6	11417.0	11692.7	12057.9	12434.2
Percent Change	5.6	2.5	2.3	2.2	2.1	2.7	3.2	3.3	2.4	3.1	3.1
<b>Implicit Price Deflator (2000=1.000)</b>											
November	1.134	1.146	1.152	1.150	1.159	1.165	1.115	1.146	1.168	1.190	1.212
Percent Change	2.0	4.0	2.3	-0.6	2.9	2.1	2.9	2.8	1.9	2.0	1.8
September	1.134	1.146	1.154	1.160	1.166	1.172	1.115	1.149	1.174	1.196	1.217
Percent Change	2.0	4.1	2.8	2.0	2.2	1.9	2.9	3.0	2.2	1.9	1.8
<b>Real Personal Income (Billions of Chained 2000 Dollars)</b>											
November	9450.7	9514.5	9597.8	9722.6	9790.2	9857.5	9183.2	9571.4	9889.7	10245.4	10669.5
Percent Change	7.2	2.7	3.6	5.3	2.8	2.8	2.3	4.2	3.3	3.6	4.1
September	9385.6	9435.1	9503.3	9575.2	9656.6	9734.8	9183.2	9474.8	9776.2	10146.1	10558.0
Percent Change	4.3	2.1	2.9	3.1	3.4	3.3	2.3	3.2	3.2	3.8	4.1
<b>Wage and Salary Employment</b>											
November	134.72	135.13	135.50	135.85	136.16	136.53	133.46	135.30	136.73	138.70	140.86
Percent Change	1.7	1.2	1.1	1.0	0.9	1.1	1.5	1.4	1.1	1.4	1.6
September	134.72	135.13	135.49	135.86	136.21	136.60	133.46	135.30	136.82	138.71	140.59
Percent Change	1.7	1.2	1.1	1.1	1.0	1.2	1.5	1.4	1.1	1.4	1.4
<b>Unemployment Rate</b>											
November	4.73	4.63	4.73	4.83	4.88	4.94	5.06	4.73	4.96	4.93	4.66
September	4.73	4.63	4.73	4.77	4.84	4.89	5.06	4.72	4.91	4.92	4.75
<b>Mortgage Rate</b>											
November	6.24	6.60	6.57	6.38	6.37	6.20	5.86	6.45	6.26	6.54	6.95
September	6.24	6.60	6.77	6.81	6.80	6.78	5.86	6.60	6.80	6.99	7.25
<b>3 Month T-Bill Rate</b>											
November	4.43	4.68	4.91	4.77	4.75	4.63	3.14	4.70	4.57	4.41	4.55
September	4.43	4.68	5.08	5.35	5.35	5.18	3.14	4.88	5.04	4.66	4.80

Table 3

**Washington Forecast Comparison**

	2006Q1	2006Q2	2006Q3	2006Q4	2007Q1	2007Q2	2005	2006	2007	2008	2009
<b>Real Personal Income (Billions of Chained 2000 Dollars)</b>											
November	207.390	206.794	213.085	213.393	215.391	217.129	200.147	210.166	219.580	230.066	241.217
Percent Change	10.3	-1.1	12.7	0.6	3.8	3.3	0.0	5.0	4.5	4.8	4.8
September	207.062	208.441	214.245	213.614	215.879	217.907	200.364	210.840	220.447	231.360	242.596
Percent Change	10.2	2.7	11.6	-1.2	4.3	3.8	0.1	5.2	4.6	5.0	4.9
<b>Personal Income</b>											
November	235.255	236.912	245.497	245.483	249.549	252.849	223.151	240.786	256.395	273.899	292.420
Percent Change	12.6	2.8	15.3	0.0	6.8	5.4	2.9	7.9	6.5	6.8	6.8
September	234.883	238.860	247.236	247.740	251.757	255.341	223.392	242.180	258.894	276.807	295.342
Percent Change	12.5	6.9	14.8	0.8	6.6	5.8	2.9	8.4	6.9	6.9	6.7
<b>Wage and Salary Employment</b>											
November	2839.1	2859.2	2881.0	2894.6	2912.0	2928.3	2777.0	2868.5	2935.6	3001.2	3059.6
Percent Change	4.4	2.9	3.1	1.9	2.4	2.3	2.8	3.3	2.3	2.2	1.9
September	2839.5	2851.4	2867.0	2881.6	2898.2	2914.5	2777.3	2859.9	2922.8	2987.6	3042.5
Percent Change	4.3	1.7	2.2	2.1	2.3	2.3	2.8	3.0	2.2	2.2	1.8
<b>Manufacturing Employment</b>											
November	282.4	283.6	287.6	288.9	290.9	291.2	271.9	285.6	292.0	293.5	293.6
Percent Change	8.1	1.8	5.7	1.9	2.8	0.4	3.1	5.0	2.2	0.5	0.0
September	281.8	282.6	284.4	286.8	289.7	290.5	272.0	283.9	291.0	292.8	293.1
Percent Change	7.2	1.1	2.6	3.5	4.1	1.1	3.1	4.4	2.5	0.6	0.1
<b>Construction Employment</b>											
November	190.9	194.1	197.3	198.3	199.7	200.1	177.4	195.2	200.3	201.9	202.7
Percent Change	18.1	6.9	6.7	2.0	2.9	0.9	8.1	10.0	2.6	0.8	0.4
September	190.9	193.2	194.1	194.0	195.1	195.6	177.4	193.1	195.9	197.7	198.6
Percent Change	17.8	5.1	1.8	-0.2	2.3	0.9	8.1	8.8	1.5	1.0	0.4
<b>Housing Permits</b>											
November	47.516	51.247	52.224	51.746	49.964	51.215	52.988	50.683	50.825	50.312	47.431
Percent Change	-53.9	35.3	7.8	-3.6	-13.1	10.4	5.8	-4.3	0.3	-1.0	-5.7
September	47.516	51.247	50.120	49.662	49.177	49.666	52.988	49.636	49.676	48.953	46.643
Percent Change	-53.9	35.3	-8.5	-3.6	-3.9	4.0	5.8	-6.3	0.1	-1.5	-4.7

Advisor's Name: \_\_\_\_\_

**Forecast Worksheet**  
**October 27, 2006**

	2006:Q4	2007	2008	2009:1,2
<b><u>U.S.</u></b>				
<b>Real GDP, %Ch</b>				
Baseline	2.6	2.4	3.3	3.1
Your Opinion	_____	_____	_____	_____
<b>Implicit Price Deflator, % Ch</b>				
Baseline	-0.6	1.9	2.0	1.9
Your Opinion	_____	_____	_____	_____
<b>Mortgage Rate, Percent</b>				
Baseline	6.4	6.3	6.5	6.9
Your Opinion	_____	_____	_____	_____
<b>Oil Price (WTI)</b>				
Baseline	63.7	65.6	64.7	64.2
Your Opinion	_____	_____	_____	_____

**Probability next recession begins on or before 2009Q2** \_\_\_\_\_

**Washington State**

<b>Real Personal Income, % Ch*</b>				
Baseline	0.6	4.5	4.8	4.2
Your Opinion	_____	_____	_____	_____
<b>Wage and Salary Employment, % Ch*</b>				
Baseline	1.9	2.3	2.2	1.8
Your Opinion	_____	_____	_____	_____
<b>Manufacturing Employment, % Ch*</b>				
Baseline	1.9	2.2	0.5	0.3
Your Opinion	_____	_____	_____	_____
<b>Construction Employment, % Ch</b>				
Baseline	2.0	2.6	0.8	0.2
Your Opinion	_____	_____	_____	_____
<b>Housing Permits (Thousands)</b>				
Baseline	51.7	50.8	50.3	48.1
Your Opinion	_____	_____	_____	_____
<b>Washington Average Annual Wage, % Ch*</b>				
Baseline	-6.7	3.5	4.1	3.2
Your Opinion	_____	_____	_____	_____

\* Please see important table on page three of the memo.